



## Accounting and the Economics of the Trade Deficit

A negative trade balance has been a feature of the 1990's U.S. economic expansion. Although both real exports and imports have grown sharply, the trade deficit has increased as the growth of total demand in the economy (including exports) has outstripped the growth of productive capacity. In popular discussions, the trade deficit often is referred to as a "subtraction" from GDP. The third quarter of 1999 is typical. During the quarter, the output of the U.S. economy measured by GDP (in chained 1996 dollars) increased \$122 billion, at an annual rate, relative to the previous quarter. The trade deficit on goods and services increased \$19.2 billion, at an annual rate. Did the trade deficit therefore "subtract" \$19.2 billion from the increase in GDP? Would GDP necessarily have been that much larger if the trade deficit had not changed?

The popular and often stated notion that the trade deficit subtracts from GDP perhaps is due to some confusion between international economics and national income accounting. To measure the production of the economy in a timely fashion, government statisticians collect a broad set of data that includes the total sales of all goods, both domestic and imported. From these initial data, an estimate of domestic production is obtained by subtracting both total imports and the change in business inventories. In this accounting, the trade deficit is indeed a subtraction—but not from GDP, rather only from an initial estimate of total sales.

Economic analysis also suggests that the answer to the above question is "No." Some imported goods, such as certain agricultural products, cannot be produced in this country, while other imports provide lower-cost products for both consumers and firms. Production at some firms might decrease, not

increase, if imported products were not available. Further, in the current economy, some firms might find it difficult to hire enough labor to expand output by the size of the trade deficit. Labor markets are tight. More than 64 percent of the working-age population is employed and the unemployment rate is just above 4 percent.

The basic economics of trade deficits are well known. With floating exchange rates, a trade deficit can persist only if foreigners willingly accumulate financial claims issued by the country's households and firms, that is, only if foreigners continue to invest in the United States. Otherwise, the foreign exchange value of the dollar would fall, and the trade gap would tend to close as the prices of imports increase and the prices of exports decrease. At the same time, of course, the yields available on domestic investments (adjusted for default, liquidity, and exchange-rate risk) must remain attractive to foreign investors. Economists view the trade deficit as part of an overall general equilibrium involving domestic demand, production and investment opportunities, relative to economic conditions in the rest of the world. Hence, in neither national income accounting nor economic analysis is the trade deficit appropriately regarded as a subtraction from GDP.

—Richard G. Anderson

